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In The

Supreme Court of the United States

October Term, 1995

THE SANTA CRUZ OPERATION, INC., a California corporation, LARS H. TURNDAL, DAN E. STEIMLE, DOUGLAS L. MICHELS, and LAWRENCE MICHELS,

Petitioners,

v.

DR. STEPHEN MOSKOWITZ, LENORA ISAACS, JERRY KATZ, IRA ROLLOVER, and DAVID ACKERMAN, on behalf of themselves and all others similarly situated,

Respondents.

Petition For Writ Of Certiorari
To The Court Of Appeal Of California
Sixth Appellate District

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

In the absence of Securities and Exchange Commission regulations requiring disclosure of health or affirmative statements regarding a director's health or continued service, do Sections 11 and 12(2) of the Securities Act of 1933 require that a company disclose in its prospectus and registration statement that a director is in ill health, where to do so would violate the Americans with Disabilities Act?

OTHER PARTIES

In addition to petitioners, Goldman, Sachs & Co. and Donaldson, Lufkin & Jenrette Securities Corporation appeared as defendants-appellees before the California Court of Appeal below.

DISCLOSURE PURSUANT TO RULE 29.6

Petitioner The Santa Cruz Operation, Inc. has no parent company. The following subsidiaries of The Santa Cruz Operation are nonwholly-owned subsidiaries:

1) The Santa Cruz Operation Pty. Ltd.;

2) The Santa Cruz Operation de Mexico, S. de R.L. de C.V.; and

3) The Santa Cruz Operation Kabushiki Kaisha.

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OPINIONS BELOW

The opinion of the Court of Appeal of the State of California, Sixth Appellate District, reversing the Superior Court's grant of a demurrer in favor of petitioners, is reprinted as Appendix A, at page A1. (References to the appendices bound with this Petition are styled ("A ___")). After petitioners filed a timely petition for rehearing, the court of appeal issued an order modifying its earlier opinions and denying the petition for rehearing. This order is reprinted as Appendix B, at page A26. A timely petition for review in the Supreme Court of California was denied. The order of the California Supreme Court is reprinted as Appendix C, at page A29. The order of the Superior Court of California, County of Santa Clara, from which appeal was taken, is reprinted as Appendix D, at page A30.

JURISDICTION

The decision of the Supreme Court of California denying the petition for review issued on February 14, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

STATUTORY PROVISIONS INVOLVED

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1981), provides in relevant part:

> Civil liabilities on account of false registration statement

a. In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions), or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

Section 12 of the Securities Act of 1933, 15 U.S.C. § 77l (1981), provides:

Civil liabilities arising in connection with prospectuses and commun :ations

Any person who –

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of

such security, or for damages if he no longer owns the security.

Section 102 of the Americans with Disabilities Act, 42 U.S.C. § 12112 (1995), provides in relevant part:

Section 12112. Discrimination.

(a) General rule

No covered entity shall discriminate against a qualified individual with a disability because of the disability of such individual in regard to job application procedures, the hiring, advancement, or discharge of employees, employee compensation, job training, and other terms, conditions, and privileges of employment.

* * *

(d) Medical examinations and inquiries

(1) In general

The prohibition against discrimination as referred to in subsection (a) of this section shall include medical examinations and inquiries.

* * *

(3) Employment entrance examination

A covered entity may require a medical examination after an offer of employment has been made to a job applicant and prior to the commencement of the employment duties of such applicant, and may condition an offer of employment on the results of such examination, if –

(A) all entering employees are subjected to such an examination regardless of disability;

(B) information obtained regarding the medical condition or history of the applicant is collected and maintained on separate forms and in separate medical files and is treated as a confidential medical record, except that –

(i) supervisors and managers may be informed regarding necessary restrictions on the work or duties of the employee and necessary accommodations;

(ii) first aid and safety personnel may be informed, when appropriate, if the disability might require emergency treatment; and

(iii) government officials investigating compliance with this chapter shall be provided relevant information on request; and

(C) the results of such examination are used only in accordance with this subchapter.

(4) Examination and inquiry

(A) Prohibited examinations and inquiries

A covered entity shall not require a medical examination and shall not make inquiries of an employee as to whether such employee is an individual with a disability or as to the nature or severity of the disability, unless such examination or inquiry is shown to be job-related and consistent with business necessity.

(B) Acceptable examinations and inquiries

A covered entity may conduct voluntary medical examinations, including voluntary medical histories, which are part of an employee health program available to employees at that work site. A covered entity may make inquiries into the ability of an employee to perform job-related functions.

(C) Requirement

Information obtained under subparagraph (B) regarding the medical condition or history of any employee are subject to the requirements of subparagraphs (B) and (C) of paragraph (3).

STATEMENT OF THE CASE

I. Proceedings in the Superior Court of California

On May 26, 1993, defendant The Santa Cruz Operation, Inc. ("SCO") conducted an initial public offering that is the subject of this suit. As required by Securities and Exchange Commission ("SEC") regulations, the SCO Registration Statement and Prospectus ("Prospectus") noted that Mr. James Harris was an outside director and chairman of the board, that more than five months earlier he had served 32 days as interim president and chief executive officer, that he sat on the audit and compensation committees, that he had been granted stock options, that he was a former Microsoft Corporation employee, and that SCO compensated him for time spent on SCO matters. Each of these disclosures was explicitly required

under SEC Regulation S-K, 17 C.F.R. § 229.401 *et seq.* The Prospectus contained no other mention of Mr. Harris, but warned that the "Company's success depends in part upon its executive officers, none of whom are subject to long-term employment contracts" and that the "loss of any current executive officer could adversely affect the Company's business."

On July 14, 1993, SCO announced that Mr. Harris had died. The next day, SCO announced that its third quarter earnings would be below market expectations. Immediately following the earnings announcement, SCO's stock price dropped. Shortly thereafter, plaintiffs filed suit alleging violations of the federal securities laws. Although plaintiffs originally asserted claims in federal court based primarily on the disappointing earnings announcement, those claims were voluntarily dismissed in favor of a complaint filed in the Superior Court of California, Santa Clara County. The state court complaint alleged, *inter alia*, that defendants SCO, Lars H. Turndal, Dan E. Steimle, Douglas L. Michels, and Lawrence Michels (collectively the "SCO defendants") violated Sections 11, 12(2), and 15 of the Securities Act of 1933 by failing to disclose Mr. Harris's declining health in the Prospectus.

SCO demurred to the complaint arguing, among other things that: SCO had no duty to disclose Mr. Harris's health in the Prospectus because plaintiffs could not identify an affirmative representation that was rendered misleading by the omission; because Mr. Harris was an outside director, his health was immaterial as a matter of law; and that any duty to disclose Mr. Harris's health would violate the express terms of the Americans with Disabilities Act, 42 U.S.C. § 12101 *et seq.* (the

"ADA"). The superior court sustained the demurrer, finding that there was no duty to disclose Mr. Harris's health and granted plaintiffs leave to amend. After plaintiffs amended, SCO demurred again and the court sustained the second demurrer with prejudice. (A30-A32).

II. Proceedings in the Court of Appeal of California

The court of appeal reversed, holding that the references to Mr. Harris in the Prospectus, all of which were required under SEC Regulation S-K and none of which mentioned his health, nevertheless "convey[ed] the overall impression of a person whose health permitted a certain level of active participation in the Company's affairs." (A22). The court of appeal did not address the defendants' contention that requiring disclosure of health would create a conflict with the Americans with Disabilities Act.

SCO petitioned the court of appeal for rehearing on the grounds that the decision was inconsistent with federal law and created a conflict with the Americans with Disabilities Act. In response to these arguments, the court of appeal amended its opinion on December 4, 1995, purporting to limit its ruling to cases in which plaintiffs allege that a company knew, prior to issuing a prospectus, that an officer or director was gravely ill. (A26-A28). The court of appeal did not, however, modify its judgment.

On December 26, 1995, defendants filed a petition for review in the Supreme Court of California. In the petition, defendants argued, *inter alia*, that the California

Supreme Court should grant review because the court of appeal's decision imposes unprecedented disclosure and due diligence obligations that are not required by the Securities Act of 1933 or rules promulgated thereunder and that conflict with the Americans with Disabilities Act. On February 14, 1996, the California Supreme Court denied the petition for review. (A29). Defendants' motion in the court of appeal for a stay of issuance of remittitur pending determination of this petition for a writ of certiorari was granted on February 27, 1996.

REASONS FOR GRANTING THE WRIT

The Court should grant certiorari in this case for the following two related reasons: First, the court of appeal has ruled on an important question of federal law in a way that conflicts with the clear language of Sections 11 and 12(2), the 1933 Act's legislative history, and applicable case law, including this Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). To state an omissions claim under Sections 11 and 12(2), plaintiffs must allege either that the omitted information was required to be disclosed under applicable SEC regulations, or that the omission rendered a particular affirmative statement misleading. Neither circumstance is present here. Health is not required to be disclosed under applicable SEC regulations, and no affirmative statement in the Prospectus was rendered misleading by the failure to disclose Mr. Harris's declining health; SCO never represented that Mr. Harris was in good health or would remain with the company for any length of time. The court of appeal's holding – that SCO may be liable for not disclosing Mr.

Harris's health even in the absence of either SEC regulations on the subject or affirmative statements regarding his health or continued service – ignores the express terms of the statute, its legislative history, the copious and specific regulations promulgated pursuant to the statute, and this Court's prior holding that "[s]ilence absent a duty to disclose is not misleading." *Basic*, 485 U.S. at 239 n.17.

The California Court of Appeal's new and unprecedented disclosure obligation imposes substantial burdens on companies. Since officers and directors are required to be identified in every prospectus or registration statement, the question of whether their health must be disclosed is present in *every* securities offering under the federal securities laws. In order to ensure compliance with the new obligation, companies will be required to investigate and disclose the health of their officers and directors. In contrast to the objective and readily identifiable information presently required to be disclosed under applicable SEC regulations, health is inherently subjective and cannot be known with certainty. Moreover, any time an officer or director falls ill shortly after a registration statement's issuance, companies will be exposed to the potential of abusive securities fraud suits alleging that there was some indication of the illness before the offering. Since the question of a director's health is, by definition, a factual one, such suits cannot be disposed of on the pleadings. This is a burden that should be imposed, if at all, by Congress or the SEC, not by a state court purporting to interpret federal law. This Court should be particularly zealous in guarding against the development of widely varying disclosure requirements

among state courts purporting to interpret the federal securities laws as they apply to nationwide securities offerings.

A second and independent basis for granting certiorari is that the court of appeal's holding creates a conflict with the express provisions of the Americans with Disabilities Act, thus giving rise to an important question of federal law that has not been, but should be, settled by the Court. Because the court of appeal held that any statement about a person in a prospectus carries with it an implication that the person is in good health, companies now will have to investigate and disclose the health of every person named in a prospectus or registration statement. Such investigations and disclosures are expressly prohibited by Section 12112 of the Americans with Disabilities Act. Companies attempting to conform their conduct with federal law cannot simultaneously comply with the ADA and with the California Court of Appeal's construction of the federal securities laws.

ARGUMENT

I. The Court of Appeal's Ruling Conflicts with Federal Law and Creates Unprecedented Investigation and Disclosure Obligations.

Under this Court's precedents, lower courts are to apply a "strict statutory construction approach to determin[e] liability under the acts." *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1444-48 (1994) (citation omitted) (eliminating aiding and abetting liability under Section 10 of the Securities Exchange Act of 1934, notwithstanding numerous circuit court decisions allowing

such actions); *accord Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1069 (1995) (applying strict statutory construction approach to determine liability under Section 12(2) of the 1933 Act); *Pinter v. Dahl*, 486 U.S. 622 (1988) (same).

Under Section 11 of the Securities Act of 1933, a party may be held liable for omitting information from a registration statement only if the information was "required [by governing SEC rules and regulations] to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k. In similar fashion, Section 12(2) limits liability for an omission to circumstances where the allegedly omitted information was "necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 77l.

In this case, there is no dispute that applicable SEC regulations do not require issuers to disclose the health of the company's officers and directors in a prospectus or registration statement.[1] Indeed, the SEC has not added

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[1] With respect to directors, issuers must provide investors the following information: (1) the amount of securities held prior to the offering and the amount being sold in the offering, 15 U.S.C. § 77aa(7), 17 C.F.R. § 229.403(b); (2) the names and ages of all directors, their positions and offices with the company, the terms of their positions as directors and the periods in which they served, any arrangement or understanding by which they were selected as directors, their prior business experience, other directorships they hold, and their involvement in certain legal proceedings, 15 U.S.C. § 77aa(4), 17 C.F.R. § 229.401; (3) compensation arrangements for services provided as a director, including additional amounts paid for committee participation and special assignments, 15 U.S.C. § 77aa(14), § 77aa(24), 17 C.F.R.

health to Regulation S-K even in the wake of cases in which companies did not disclose information about an executive's ill health.[2]

Where an item of information is not required to be disclosed under governing SEC regulations, the express terms of Sections 11 and 12(2) require plaintiffs to identify an affirmative statement that was rendered misleading by the alleged omission. Absent an affirmative statement rendered misleading by the omission, the mere fact that a company keeps information to itself will not give rise to a cause of action – no matter how material the information. *Basic Inc. v. Levinson*, 485 U.S. at 239 n.17 ("[s]ilence, absent a duty to disclose, is not misleading").

The legislative history of the 1933 Act confirms that an omission that does not render an affirmative statement

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§ 229.402(g); (4) the identity of the members of the board's compensation committee, 17 C.F.R. § 229.402(j); (5) material business relationships between the company and a director, 15 U.S.C. § 77aa(24), 17 C.F.R. § 229.404(b); and (6) any indemnification agreements with the directors, 17 C.F.R. § 229.702.

[2] In two recent examples, Reliance Group Holdings, Inc. did not disclose that its chief executive, chairman and major shareholder, Saul P. Steinberg, had suffered a stroke that left him partially paralyzed, disclosing the fact only after CNBC reported the information. James F. Peltz, *When Should a CEO's Illness be Made Public?*, L.A. Times, Aug. 19, 1995, at D1; *Saul Steinberg, Chief of Insurer Reliance Had Stroke in June*, Wall St. J., Aug. 10, 1995, at B1. Similarly, Buffets, Inc., in a presentation to securities analysts and investors, did not mention that its vice president in charge of real estate had recently died of a heart attack. Susan Antilla, *Death and the Company: Should Shareholders Know the State of the CEO's Health?*, Int'l Herald Tribune, June 27, 1994.

misleading does not give rise to liability under the securities laws. After the conference between the House and Senate on their respective versions of the bill, the House managers attached a commentary to the final version of the 1933 Act. That report addressed the distinctions between the House and Senate versions and explained how those differences were resolved. With respect to Section 11, the conference report stated as follows:

> The Senate amendment imposed liability upon persons making false and deceptive statements in connection with the distribution or sale of a security. The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. *This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances exist to make the omission in itself misleading.*

H.R. Rep. No. 152, 73rd Cong., 1st Sess. 26 (1933) (Conference Report submitted in House and agreed to May 22, 1933), 77 Cong. Rec. 3891, 3902 (1933) (emphasis added).

Consistent with this statutory and legislative language, federal courts hold that a threshold requirement for Section 11 and 12(2) liability is the identification of a particular statement rendered misleading by the alleged omission. *See, e.g., In re Bank of Boston Corp. Sec. Litig.*, 762 F. Supp. 1525, 1538 (D. Mass. 1991) (rejecting § 11 and § 12(2) claims where plaintiffs "cannot identify a single

statement in either the Registration Statement or the Prospectus that became misleading as a result of the Bank's failure to disclose certain financial information"); *In re Union Carbide Class Action Sec. Litig.*, 648 F. Supp. 1322, 1326 (S.D.N.Y. 1986) (no liability under § 11 or § 12(2) because a "threshold requirement" under both statutory provisions "is the presence of an affirmative statement that is made misleading by the material omission").[3]

When securities fraud actions are based on a company's alleged failure to disclose an executive's ill-health

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[3] Courts similarly require plaintiffs to identify the particular statements that were rendered misleading in cases arising under the Securities Exchange Act of 1934, where Rule 10b-5 (relating to all public statements) and Rule 14a-9 (relating to proxy statements) include language that is virtually identical to the language at issue in this case. *See, e.g., In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts"), *cert. denied*, 114 S. Ct. 1397 (1994); *Backman v. Polaroid Corp.*, 910 F.2d 10, 13 (1st Cir. 1990) (en banc) (rejecting claim that § 10(b) imposes liability for the nondisclosure of material information absent the identification of specific "inaccurate, incomplete, or misleading prior disclosures"); *Staffin v. Greenberg*, 672 F.2d 1196, 1204 (3d Cir. 1982) (no duty to disclose material omitted information under § 10(b) and § 14(e) absent a statement made misleading); *Ash v. Brunswick Corp.*, 405 F. Supp. 234, 245 (D. Del. 1975) (although omitted information was material, "[o]missions constitute violations of the Act only if they are both material and make other statements false or misleading").

or imminent departure, courts dismiss the action in the absence of a specific affirmative representation that the executive was healthy or would remain with the company for a particular length of time. *See, e.g., In re Quarterdeck Office Sys. Sec. Litig.*, [1993 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,646, at 96,975 (C.D. Cal. Nov. 4, 1992) (dismissing Section 11 and Section 10(b) claims where "plaintiffs fail to allege that the defendants made an affirmative statement that [the director] would remain a director of the company."); *Hines v. Data Line Systems, Inc.*, 114 Wash. 2d 127, 140, 787 P.2d 8, 15-16 (1990) (company's failure to disclose president and CEO's brain aneurysm actionable under Washington state securities laws where "the placement memorandum . . . attested to [the CEO's] good health"); *In re Registration Statement of Cytotech Corp.*, SEC Release No. 33-6800, 1988 SEC LEXIS 1905, at *3 (Sept. 29, 1988) (where sole individual responsible for research and development was suffering from leukemia and confined to home, affirmative statement in prospectus that he "considered himself to be in excellent physical condition" was misleading); *see also In re Numerex Corp. Sec. Litig.*, 913 F. Supp. 391 (E.D. Pa. 1996) (dismissing case because Chairman of the Board's resignation two months after the offering was immaterial as a matter of law).

Despite Sections 11 and 12(2)'s express language, the 1933 Act's legislative history, and the overwhelming body of federal law to the contrary, the court of appeal nevertheless allowed this action to proceed in the absence of an affirmative statement regarding Mr. Harris's health.

The court acknowledged that defendants were obliged under Regulation S-K to make statements regarding Mr. Harris (*see* A3-A5, A7-A8) and conceded that the statements "did not expressly represent that Harris was in good health." (A22). The court nevertheless held that the statements carried with them an implicit representation that Mr. Harris was in good health. (A22). If this holding is correct, then *every* prospectus which complies with Regulation S-K would contain identical "implicit representations" regarding the health of each of its officers and directors. Health would thereby become a *de facto* disclosure requirement, despite the absence of any regulatory requirement to disclose health.

Congress has bestowed the SEC with "special powers" to make any rules and regulations necessary to carry out the provisions of the Securities Act of 1933, including "rules and regulations governing registration statements and prospectuses for various classes of securities." 15 U.S.C. § 77s. Courts should not substitute their own judgment for that of the SEC in determining what information should be included. *See, e.g., Quinn & Co. v. SEC*, 452 F.2d 943, 947 (10th Cir. 1971) ("the Commission, not the courts, has the primary responsibility for protection of investors"), *cert. denied*, 406 U.S. 957 (1972); *SEC v. Murphy*, 626 F.2d 633, 647 (9th Cir. 1980) (recognizing comprehensive nature of statutory and SEC disclosure requirements).

There are good reasons why the SEC has not exercised its regulatory expertise to require that health be disclosed in a registration statement or prospectus. In

contrast to the objective and readily identifiable information presently required under governing SEC regulations, health is inherently subjective. *See, e.g., United States v. Vuitch*, 402 U.S. 62, 74 (1971) (Douglas, J., dissenting in part) (Health "is highly subjective, depend[ing] on the training and insight of the particular physician and his standard as to what is 'necessary.' . . . The answers may well differ, physician to physician."). Companies are not capable or qualified to make determinations regarding the health of an officer or director, or its potential impact on the performance of the director's duties. Moreover, because health is subjective, any time an officer or director falls ill shortly after a registration statement's issuance, a plaintiff will be able to allege that the condition was in existence at the time of the offering and was required to be disclosed. This type of litigation is particularly burdensome, moreover, because the factual issue it presents cannot be resolved at the pleadings stage.

The prevalence of shareholder class actions[4] makes the question of whether, and under what circumstances, health needs to be disclosed in a prospectus of pressing importance to thousands of executives and the companies with which they work.[5] It is not a question, moreover, that should be left to state court development of widely

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[4] Brent Bowers & Udayan Gupta, *Shareholder Suits Beset More Small Companies*, Wall St. J., Mar. 9, 1994, at B1.

[5] *See, e.g*, James F. Peltz, *When Should a CEO's Illness be Made Public?*, L.A. Times, Aug. 19, 1995, at D1; Rob Seitz, *Corporate Conundrum: Disclosing Illness in the Corner Office*, N.Y. Times, May 2, 1993, § 3, at 9; Susan Antilla, *Death and the Company: Should Shareholders Know the State of CEO's Health?*, Int'l Herald Tribune, June 27, 1994.

divergent disclosure obligations applicable to nationwide securities offerings.[6] To the contrary, it is imperative to the efficient operation of the financial markets and the securities industry that this Court ensure uniformity in the law governing nationwide securities offerings. Given the uncertainty that presently exists on this issue, its importance in the determination of shareholder securities suits, and the question's broader policy implications, the question is one that the Court should address.

II. The Court of Appeal's Ruling Conflicts with the Americans with Disabilities Act.

The court of appeal's decision that health must be disclosed, and the investigations that would be the practical result of this holding, violate the express provisions of the Americans with Disabilities Act of 1990, 42 U.S.C. § 12101 *et seq.*[7] Because Section 11 does not require proof

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[6] In recent months there has been a marked increase in state court filings of federal securities claims. *See* Robert Ablon, *New Front in Shareholder Suits*, The Recorder, Apr. 2, 1996, at 1; Luther Zeigler & Scott L. Winkelman, *Honoring State Class Action Settlements*, Prentice Hall Law & Bus. Insights, Apr. 1996, at 2; Dennis J. Block & Jonathan M. Hoff, *Release of Federal Claims in State Class Settlements*, N.Y. Law J., Feb. 15, 1996, at 5.

[7] *See* Andrew K. Glenn, *Disclosure of Executive Illness Under the Federal Securities Law and the Americans with Disabilities Act of 1990: Hobson's Choice or Business Necessity?*, 16 Cardozo L. Rev. 537 (1994); *Securities Disclosure*, Bowne Digest for Corporate and Securities Lawyers, Sept. 1995, at 1 (Bowne & Co., New York, N.Y.) (abstract of Glenn article).

of scienter, a company defendant cannot avoid liability for the failure to disclose ill health by simply asserting its ignorance of the adverse health of its officers or directors.[8] *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). Likewise, individual defendants are obliged to conduct due diligence in order to satisfy the requirements of their statutory defenses. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 n.26 (1976). Accordingly, as a practical matter, the only way in which defendants will be able to mitigate the threat of such lawsuits is by requiring thorough medical examinations of every person[9] named in a prospectus or registration statement and then disclosing to the public any potentially serious health problems uncovered by those exams.[10] This is precisely what the Americans with Disabilities Act prohibits.

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[8] For this reason, the court of appeal's purported attempt to limit its holding to cases in which plaintiffs allege that the defendants knew at the time of the offering that an executive was ill (A28, n.4) is unavailing.

[9] Plaintiffs will claim that asking the officer or director about his health would be insufficient to establish a due diligence defense. *See, e.g., In re Software Toolworks, Inc. Sec. Litig.*, 50 F.3d 615, 626 (9th Cir. 1994) (issue of fact as to underwriters' due diligence defense where underwriters "did little more than rely on [the company's] assurances that the transactions were legitimate"), *cert. denied*, 116 S. Ct. 274 (1995).

[10] Because an issuer must identify in the prospectus all "significant employees" such as production managers, sales managers, or research scientists who are expected to make substantial contributions to the business of the registrant, 17 C.F.R. § 229.401(c), an investigation would need to be made of those people as well.

The Americans with Disabilities Act is a landmark piece of civil rights legislation.[11] Among the stated purposes of the ADA are to "provide a clear and comprehensive national mandate for the elimination of discrimination against individuals with disabilities" and "to provide clear, strong, consistent, enforceable standards addressing discrimination against individuals with disabilities." 42 U.S.C. § 12101(b)(1)-(2).

Title I of the ADA, which contains the provisions relating to discrimination in employment, became effective on July 26, 1992. The general rule of this title prohibits discrimination "against a qualified individual with a disability because of the disability of such individual in regard to job application procedures, the hiring, advancement, or discharge of employees, employee compensation, job training, and other terms, conditions, and privileges of employment." 42 U.S.C. § 12112.[12]

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[11] Nancy Lee Jones, *Overview and Essential Requirements of the Americans with Disabilities Act*, 64 Temp. L. Rev. 471 (1991) ("The ADA is the most significant civil rights legislation since the Civil Rights Act of 1964.").

[12] Long-term debilitating illnesses such as cancer and AIDS are considered disabilities under the ADA. 42 U.S.C. § 12102(2); *see, e.g., EEOC v. Chrysler Corp.*, ___ F. Supp. ___, 1996 WL 103501 (E.D. Mich. Mar. 6, 1996) (diabetes constitutes a disability under the ADA); *Abbott v. Bragdon*, 912 F. Supp. 580 (D. Me. 1995) (asymptomatic HIV constitutes a physical disability under the ADA).

In enacting the ADA, Congress explicitly recognized that publicly disclosing an individual's disability, without more, is a form of discrimination:

> While the employer might argue that it does not intend to penalize the individual, the individual with cancer may object merely to being identified, independent of the consequences. As was made abundantly clear before the Committee, being identified as disabled often carries both blatant and subtle stigma.

H.R. Rep. No. 101-485(II), 101st Cong., 2d Sess. 75 (1990), *reprinted in* 1990 U.S.C.C.A.N. 303, 358.

Accordingly, the ADA strictly circumscribes those situations under which an employer may obtain or disclose medical information about an employee. An employer may not require a medical examination or "make inquiries of an employee as to whether such employee is an individual with a disability or as to the nature or severity of the disability" unless the examination or inquiry is shown to be "job-related and consistent with business necessity,"[13] and any medical information

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[13] 42 U.S.C. § 12112(d)(4)(A). Plaintiffs' allegation that Mr. Harris had recently become less active in company affairs does not eliminate the ADA's prohibition on requiring Mr. Harris to submit to a medical examination. The fact that an outside director has postponed a few meetings does not satisfy the "business necessity" requirement:

> if an employee suddenly starts to use increased amounts of sick leave or starts to appear sickly, an employer could not require that employee to be tested for AIDS, HIV infection, or cancer unless the

that is obtained by an employer must be kept strictly confidential.[14]

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employer can demonstrate that such testing is job-related and consistent with business necessity.

"Interpretive Guidance on Title I of the Americans with Disabilities Act," 29 C.F.R. Pt. App. § 1630.13(b), 56 Fed. Reg. 35,750 (1991); *accord* S. Rep. No. 101-116, 101st Cong., 1st Sess. 37-38 (1989) (medical examinations and inquiries must be "carefully tailored to measure the person's actual ability to do an essential function of the job"); *see also Doe v. Kohn Nast & Graf*, 866 F. Supp. 190, 197 (E.D. Pa. 1994) ("An employer may not make a medical inquiry or require a plaintiff to submit to testing to confirm its suspicions about the nature of an employee's illness. . . . "); *Roe v. Cheyenne Mountain Conference Resort*, ___ F. Supp. ___, 1996 U.S. Dist. LEXIS 538 (D. Colo. Jan. 11, 1996) (policy requiring employees to disclose prescription medication not job-related or consistent with business necessity); *Yin v. State of Cal.*, No. C94-20116 JW, 1994 WL 59043, at *3 (N.D. Cal. Oct. 21, 1994) ("business necessity" requirement satisfied where tax auditor used over 400 hours of sick leave in one year and was subject to dizzy spells that severely limited her ability to drive to audit sites).

[14] 42 U.S.C. § 12112(d)(4)(C) (referring to § 12112(d)(3)) (all information regarding the medical condition or history of an employee must be collected and maintained in separate medical files and "treated as a confidential medical record")

The following are the only situations under which a company may disclose an employee's disability:

(i) supervisors and managers may be informed regarding necessary restrictions on the work or duties of the employee and necessary accommodations;

(ii) first aid and safety personnel may be informed, when appropriate, if the disability might require emergency treatment; and

Thus, if the court of appeal's decision is allowed to stand, companies that hope to offer shares to the public will be faced with a Hobson's Choice: allow officers and directors to keep their health private and risk a securities lawsuit should one of them fall seriously ill or die shortly after the offering, or violate the ADA by investigating and disclosing the health problems of every officer and director mentioned in the prospectus.[15] This conflict gives rise to an important question of federal law that has not been, but should be, settled by the Court.

Moreover, requiring the disclosure of officers' and directors' adverse health conditions is likely to have a

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> (iii) government officials investigating compliance with this chapter shall be provided relevant information on request.

42 U.S.C. § 12112(d)(3)(B).

[15] Further, SCO could not rely on Section 1630.15(e) of the EEOC regulations implementing the ADA as a defense to a claim of discrimination. This section states:

> There are several Federal laws and regulations that *address medical standards and safety requirements*. If the alleged discriminatory action was taken in compliance with another Federal law or regulation, the employer may offer its obligation to comply with the conflicting standard as a defense.

29 C.F.R. Pt. App. § 1630.15(e) (emphasis added). This section is inapplicable in the present case since there is no SEC regulation addressing medical standards in connection with required disclosures in a prospectus. *Cf. Campbell v. Federal Express Corp.*, 918 F. Supp. 912 (D. Md. 1996) (employer could rely on compliance with a Department of Transportation regulation entitled "Instructions for Performing and Recording Physical Examinations" as a defense to an employee's claim under the ADA).

substantial chilling effect on the willingness of individuals to serve as officers and directors of public companies. Since the health of executives may now become an issue in every public offering, the issuer and the underwriters (and their respective doctors) may be pitted against the officer or director (and his doctor). There is no end to the medical information which could be deemed material at the expense of the officer or director's privacy. When confronted with the prospect of revealing their medical records to the company, to the underwriters, to their respective counsel, and ultimately to the public, executives with disabilities may choose simply to resign prior to the offering, rather than subject themselves to the scrutiny and subsequent public disclosure that the court of appeal's ruling requires. Similarly, an issuer may decide not to employ an executive who suffers from cancer, AIDS, or other disability because of the obligations imposed by the court's ruling and the inherent uncertainties involved in any illness-related disclosure. These are the very results that the ADA was enacted to prevent.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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May 14, 1996

APPENDIX A

NOT FOR PUBLICATION

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA

SIXTH APPELLATE DISTRICT

STEPHEN MOSKOWITZ, et al.,

Plaintiffs and Appellants,

v.

THE SANTA CRUZ OPERATION, INC., et al.,

Defendants and Respondents.

H012757
(Santa Clara County Super.Ct. No. 735858)

(Filed Nov. 18, 1995)

The plaintiffs are investors who bought stock in Santa Cruz Operations, Inc. (SCO) in the course of a public offering. Defendants are SCO, three SCO officers and directors, the former President and Chief Executive Officer of SCO and the underwriters of the stock offering. Plaintiffs claim defendants violated federal securities laws by failing to disclose in the offering prospectus that James Harris, chairman of SCO's Board of Directors, was terminally ill and consequently was curtailing his involvement with SCO affairs. (§§ 11, 12(2), and 15 of the Securities Act of 1933 (the Securities Act), 15 U.S.C. §§ 77k, 77l(2), 77o.) Plaintiffs appeal from a judgment of dismissal entered after defendants' demurrer to their second amended and consolidated complaint was sustained without leave to amend.

We find that plaintiffs' allegations are sufficient to state a cause of action for a violation of section 11 of the Securities Act. We therefore reverse the judgment of dismissal.

STANDARD OF REVIEW

The trial court's decision to sustain a demurrer without leave to amend is subject to our de novo review. (*Koll-Irvine Center Property Owners Assn. v. County of Orange* (1994) 24 Cal.App.4th 1036.) We must accept as true all properly pleaded facts, unless they are contradicted by matters judicially noticed. (Code Civ. Proc., §§ 430.30, subd. (a); *B & P Development Corp. v. City of Saratoga* (1986) 185 Cal.App.3d 949, 953; *Fundin v. Chicago Pneumatic Tool Co.* (1984) 152 Cal.App.3d 951, 955.) Here, the pleadings quoted and otherwise extensively referred to the prospectus and the trial court properly took judicial notice of the entire prospectus. (See, e.g., *Fundin v. Chicago Pneumatic Tool Co., supra*, at p. 955; *Cantu v. Resolution Trust Corp.* (1992) 4 Cal.App.4th 857, 877.) We will take the facts from the second amended complaint and from the prospectus itself.

FACTS

SCO is a California corporation which provides software for computer systems. In April of 1993, SCO filed with the Securities and Exchange Commission (SEC) a notice of intent to proceed with an initial public offering. The registration statement and prospectus for the public offering were dated May 26, 1993. Six million shares of common stock were offered at $12.50 per share.

According to the prospectus, SCO had experienced substantial growth from 1986 through 1991, achieving profitability in fiscal year 1992. It had been profitable in each of the past six fiscal quarters. The future success of the company would depend on the continued growth of the existing market for its products as well as its ability to identify new markets and to develop additional products. In a section entitled "Key Personnel," the prospectus also stated that the company's continued success would depend in part on its executive officers, the loss of any one of which "could adversely affect the Company's business." None of the "key personnel" was identified by name; however, the reader was referred to a section entitled "Management."

Under the heading "Management" were listed the "Executive Officers and Directors." At the top of the list was James W. Harris, age 49, whose position with SCO was described as "Chairman of the Board." He was also listed as one of two members of the Compensation Committee (the other member was not yet named) and one of two directors comprising the Audit Committee. He had been a director of SCO since March of 1988 and had also served for a brief time in December of 1992 and January of 1993 as SCO's President and Chief Executive Officer.

Several pages later, the prospectus stated that Harris was the only SCO director to receive cash compensation. He was paid $1,000 per day, plus expenses, for consulting services, including his services as Chairman of the Board, which services were provided on an as needed basis.

Since the beginning of the company's last fiscal year, Harris had been paid a total of $59,076 in compensation.[1]

In addition to this compensation, Harris had been granted various stock options, which were described in the prospectus. Most recently, in May of 1993, the same month the prospectus was issued, he had been granted an option for 15,000 shares of common stock at $12.00 per share, exercisable at the rate of 750 shares for every three months he served as a consultant. In December of 1992, he had been granted an option to purchase 2,500 shares, at $3.75 per share, for every three months he served as a director. He also possessed options to purchase 27,500 shares at $3.75 per share, 20,000 shares at $0.41 per share and 4,667 shares at $1.25 per share, currently exercisable.

The prospectus described Harris's function as one of two directors on the Compensation Committee. The Compensation Committee made recommendations to the board concerning salaries and incentive compensation for SCO employees and consultants. Harris was again referred to here as having been the President and Chief Executive Officer of the company from December 1992 to January 1993.

In addition to his membership on the Compensation Committee and the Audit Committee, Harris and Lars Turndal, the current President and CEO of the company, were the only two members of the Incentive Stock Committee, which was responsible for administering SCO's 1984 Incentive Stock Option Plan. In a subsequent section

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[1] SCO's fiscal year runs from October 1 through September 30.

entitled "1993 Director Option Plan" the prospectus noted that several directors, including Harris, had been granted stock options which were exercisable based on their continued service as directors. As to Harris, the exercisability of one-half of his options was accelerated in January of 1993 when he was replaced as President and CEO and became Chairman of the Board.

A section in the prospectus entitled "Certain Transactions" explained recent changes in upper level management at SCO. In December of 1992, the company's President and CEO, Lawrence Michels, resigned pursuant to the settlement of a lawsuit against him and SCO alleging employment discrimination and sexual harassment. Michels agreed to provide services as a consultant for SCO and SCO agreed to fill the vacancy on the board represented by Michels' departure with someone designated by him. The position of President and CEO was taken over by Harris until Lars Turndal, then the Senior Vice President of the company, succeeded to that position in January of 1993, at which time Harris became Chairman of the Board.

Also under the heading "Certain Transactions," the prospectus again described the consulting agreement between Harris and SCO.

The last mention of Harris in the prospectus appeared in a list of principal shareholders. He was listed as owning, prior to the offering, 55,000 shares, issuable upon the exercise of options exercisable within 60 days after May 14, 1993.

Harris died on July 10, 1993. SCO announced his death on July 14, 1993, approximately six weeks after the

initial public offering. Around the same time SCO announced that third quarter earnings had declined. By July 16, 1993, stock prices had fallen from the initial offering price of $12.50 to below $5.00 per share. Plaintiffs filed their complaint shortly thereafter.

Plaintiffs alleged that each of the defendants was actively and directly involved in the public offering and in solicitation efforts to sell SCO shares to the investing public. With the exception of defendant Lawrence Michels, all defendants were members of the "working group" which participated in drafting and revising the prospectus for the public offering. Initially Harris was also part of the "working group."

Plaintiffs alleged that at the time of the public offering defendants knew that Harris was terminally ill and they were aware that he had been forced to curtail his business activities on behalf of SCO because of that illness, from which he died less than two months later. It is further alleged that as early as January of 1993, when preliminary work for the public offering was underway, defendants became aware of Harris's terminal illness. Among other things, Harris's participation with the working group was affected when he began to cancel meetings with representatives of the underwriters. Harris's illness, and the adverse impact his death would have on the company, were discussed in written communications circulated in February 1993 among the members of the working group for the public offering. Harris had been advised, prior to the public offering, to get his personal affairs in order. Defendants knew that Harris would be unable to play any meaningful role in the

company or on its board of directors after the public offering.

Plaintiffs alleged that the descriptions in the prospectus of Harris's various positions and functions at SCO represented him as a "key" individual at the company and conveyed the impression that he would have a continuing and important role with SCO. Plaintiffs alleged further that these representations about Harris in the prospectus were made materially false and misleading by defendants' failure to disclose the information that Harris was terminally ill, that he was curtailing his involvement in company matters and that he would likely not be able to continue serving in his numerous corporate capacities.

These allegations, plaintiffs claim, are sufficient to state the elements of liability for a violation of section 11 of the Securities Act (15 U.S.C. 77k, hereafter § 11.) They further claim that they have stated a basis for extending liability to all defendants under section 12(2) of the Act (15 U.S.C. § 77l(2), hereafter § 12(2)), as "sellers" of the security, and to all the individual defendants under section 15 (15 U.S.C. 77o, hereafter § 15), as persons with control over those with primary liability. Finally, as to defendant Lawrence Michels, plaintiffs argue that section 11 liability extends to him under section 11(2) (a), as a person "performing similar functions" to those of a director.

RELEVANT FEDERAL SECURITIES LAW

The Securities Act and the SEC Regulations set forth at length the information which is required to be disclosed in a registration statement when the issuer of a

security registers it with the SEC. (15 U.S.C. § 77aa; Regulation S-K, 17 C.F.R. Pt. 229.) With certain exceptions, the same information is required to be included in the prospectus. (15 U.S.C., § 77j.)

The Securities Act was enacted after the 1929 stock market crash and was intended to provide increased protection to purchasers of registered securities. (*Ernst & Ernst v. Hochfelder* (1976) 425 U.S. 185, 218.) Section 11 of the Act creates a right of action against certain enumerated parties in favor of an investor who purchases a registered security. A plaintiff states a claim under section 11 if the registration statement contains a false statement of material fact, if it omits a material fact which is required by law to be included or, as is relevant to this case, if it "omit[s] to state a material fact . . . necessary to make the statements therein not misleading." (15 U.S.C. § 77k(a).)

Section 11 "was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering." (*Herman & MacLean v. Huddleston* (1983) 103 S.Ct 683, 687, fn. omitted.) Thus section 11 "places a relatively minimal burden on a plaintiff." (*Ibid.*) A prima facie case is established by showing that there was a material misrepresentation or omission in the prospectus. Scienter is not an element of a section 11 violation. (*Ibid.*)

Section 11 imposes liability on, among others, the issuer of the securities, the signers of the registration statement, the directors of the issuing company, persons

"performing similar functions" as directors, and the underwriters. (§ 11(a), subds. (1) through (5).)

Section 11 is limited to statements made in a prospectus or registration statement. (*In re Lyondell Petrochemical Co. Securities Lit.* (9th Cir. 1993) 984 F.2d 1050, 1052, fn. 5.) Statements made in analysts' reports, roadshow presentations or press releases cannot support a section 11 claim. (*O'Sullivan v. Trident Microsystems, Inc.* (N.D. Cal. 1994) [1993 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 98,116.)

Section 12(2) closely resembles section 11. Section 12(2) imposes liability upon any person who "offers or sells a security by the use of . . . interstate commerce or of the mails, [or] by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. . . . " (15 U.S.C. 77l(2).) Thus an investor asserting a claim under section 12(2) need only allege 1) that the prospectus contained a material misrepresentation or omission and 2) that defendant offered or sold the security at issue.

Section 15 imposes secondary liability on persons who "control" those liable under sections 11 and 12. (15 U.S.C. § 77o).

The Section 11 Claim

Defendants attack plaintiffs' section 11 claim on two fronts. They argue that even if the facts as alleged by plaintiffs are accepted as true, there was no legal duty to

disclose Harris's illness in the prospectus because no particular statement in the prospectus was rendered misleading by the omitted information. Second, defendants contend that the state of Harris's health was not material because Harris was merely an "outside director" and his role at SCO was limited.

a. Duty to Disclose

Section 11 does not require disclosure of all information material to the company's business. "A company . . . need not detail every corporate event, current or prospective. . . . " (*Marx v. Computer Sciences Corporation* (9th Cir. 1974) 507 F.2d 485, 491; *In re Convergent Technologies Securities Lit.* (9th Cir. 1991) 948 F.2d 507, 516.) To do so would "bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decisionmaking." (*TSC Industries, Inc. v. Northway, Inc.* (1976) 426 U.S. 438, 448-449; *In re Convergent Technologies, supra,* at p. 516.) Thus the duty to disclose arises only where statements made in the prospectus are rendered misleading by the alleged omission. (*Capri Optics Profit Sharing v. Digital Equipment* (D. Mass. 1991) 760 F. Supp. 227, 232 ["a duty arises only to reveal those facts 'that are needed so that what was revealed would not be so incomplete as to mislead.' "].)

The House Conference Report accompanying the 1933 Act in its final form explained that the language of section 11 was not intended to impose liability for a "mere omission . . . where no circumstances exist to make the omission in itself misleading." Rather, the omission must "relate to the statements made in order that these

statements shall not be misleading. . . . " (H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 at p. 277 (1933).)

Defendants take these authorities to mean that no duty to disclose arises under section 11 unless plaintiffs can first identify a particular affirmative statement in the prospectus which is rendered misleading by the alleged omission. As applied to our case, they argue that they had no duty to disclose Harris's terminal illness because the SCO prospectus contained no affirmative representation that he was in good health or that he would be continuing his activities with the company. Although there is some support for defendants' position in cases which have found it appropriate to analyze claimed section 11 violations on a statement-by-statement basis,[2] we conclude that the circumstances of our case do not lend themselves to such a precise analysis. A review of the relevant caselaw will illustrate this point.

In *In re Quarterdeck Office Systems, supra,* an alleged actionable omission was the failure to disclose in the prospectus that Rosen, one of the most notable backers of the company, would resign his position as a director. The district court found plaintiffs had not stated a claim, for several reasons. First, the prospectus warned the investors, as did the prospectus in our case, that the company's success depended upon key personnel, that the loss of

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[2] See, e.g., *In re Quarterdeck Office Systems, Inc. Securities Litigation* (C.D. Cal. 1992) [1993 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 97,646; *Alfus v. Pyramid Technology Corp.* (1990) 745 F.Supp. 1511; *In re Convergent Technologies Securities Lit., supra,* 948 F.2d 507; *Kaplan v. Rose* (N.D. Cal. 1994) [1994-1995 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 98,422.

any of those key individuals could have an adverse effect on the company, and that the company could not assure that it would be successful in attracting and retaining such personnel. Second, the court found that plaintiffs had failed to identify any affirmative representation in the prospectus stating that Rosen would remain as a director of the company. Citing *Alfus v. Pyramid Technology Corp., supra,* 745 F.Supp. 1511, the court concluded that in order to be actionable, the alleged omission must "render[] misleading an actual affirmative statement by [defendant]." (*In re Quarterdeck Office Systems, Inc. Securities Litigation, supra,* [1993 Tr. Binder] Fed.Sec.L.Rep. (CCH) 97,646, at p. 96975, quoting *Alfus, supra,* 745 F.Supp. at p. 1518.) Finally, the court offered the general observation that a company need not detail " ' "every corporate event, current or prospective." ' " (*Quarterdeck* at p. 96,975, citing *In re Convergent Technologies Securities Lit., supra,* 948 F.2d at p. 516, quoting from *Marx v. Computer Sciences Corporation, supra,* 507 F.2d at p. 491.)

Although facially similar to our case, *Quarterdeck* is distinguishable in several respects. It was unclear from the pleadings in *Quarterdeck,* but it appeared that Rosen's decision to resign was not known by defendants at the time the prospectus was issued. "[T]here is no duty to disclose to the investing public the possibility that corporate officers might one day leave their employ absent a specific reason for thinking that such departure is imminent." (*Ultimate Corp. Securities Litigation* (S.D.N.Y. 1989) [1989 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 94,522 at p. 93,318, fn. omitted.) Plaintiffs in *Quarterdeck* were allowed leave to amend to plead their claim with more specificity.

In our case, however, plaintiffs have pleaded that defendants knew of Harris's declining health several months before the public offering. Indeed his health had forced him to miss meetings and otherwise withdraw from participation in the working group preparing the prospectus. Defendants were aware that Harris's diagnosis was terminal and that he had been told to wind up his personal affairs.

This distinction casts the cautionary language regarding key personnel in an entirely different light. While it may be assumed that investors will understand the risk that personnel may resign or become ill, it is quite another thing to inform investors in a general way of this risk while omitting the fact that a particular individual's loss is imminent. As one court has put it, "To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit." (*Huddleston v. Herman & MacLean* (5th Cir. 1981) 640 F.2d 534, 544, aff'd in relevant part in 459 U.S. 375.)

Quarterdeck relied on *Alfus v. Pyramid Technologies, supra*, 745 F.Supp. 1511, for the proposition that in order to be actionable an alleged omission must render misleading a specific affirmative statement in the prospectus. In *Alfus*, which involved a different, though related, section of the Securities Act, plaintiffs claimed that the statements in the prospectus gave the overall impression of continued growth for the company and that defendants had omitted information that growth rates might not continue. The court in *Alfus* found that in the absence of some affirmative statement or prediction of increased

sales, earnings or growth rates, the alleged omission was not actionable. Internal projections of this type, however, are generally not actionable. (*Vaughn v. Teledyne, Inc.* (9th Cir. 1980) 628 F.2d 1214, 1221; *O'Sullivan v. Trident Microsystems, Inc., supra,* [1994 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 98,116 at p. 98,909 [failure to disclose that company "was about to enter a period of protracted decline"]; *In re Verifone Securities Litigation* (9th Cir. 1993) 11 F.3d 865, 869 [failure to disclose that "future prospects may not be as bright as past performance"].) There is no duty to predict the future in the absence of "material, actual facts" otherwise unavailable to the market which could render the future event more certain or reliable than a mere forecast. (*Id.* at p 869-870.) Here, as plaintiffs allege, defendants were in possession of such material facts: Harris had a terminal diagnosis and as a consequence of his declining health was cutting back his involvement in company business.

The district court in *Quarterdeck* also relied on *In re Convergent Technologies Securities Lit., supra,* 948 F.2d 507. In that case the plaintiffs alleged, among other things, that the defendants had a duty to release information, as it became known to them, regarding the implementation of a new manufacturing process with regard to a certain product line. The court in *Convergent Technologies* found that the prospectus "virtually overflow[ed]" with disclosures, not only of general risks involved with the product line, but with specific reference to the problems associated with the advanced manufacturing processes. (*Id.* at p. 515.) The court found a reasonable investor could not read these disclosures without being aware there were problems with those product lines; thus no

further detail was required. It was in this context that the court observed that securities laws do not require management " 'to bury the shareholders in an avalanche of trivial information . . . ' " (*Convergent Technologies, supra,* at p. 516, quoting *TSC Industries, Inc. v. Northway, Inc., supra,* 426 U.S. at pp. 448-449.) In our case, the information that the chairman of the board was gravely ill and that he was having to curtail his participation in company affairs, can hardly be characterized as "trivial." The standard cautionary language regarding the importance of key personnel cannot be construed as an adequate disclosure under the circumstances. (See, e.g., *Kaplan v. Rose, supra,* [1994-1995 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 98,422.at p. 90,877.)

Many of these same principles are discussed in the recent case of *Kaplan v. Rose, supra.* There the court addressed a question whether defendants had a duty to disclose a clinical study which showed favorable results in only 18.5 percent of patients who had been treated with the company's shockwave system to reduce gallstones. The defendants argued that the clinical data was too speculative and premature. But the court found that the omission could have misled investors in light of statements in the prospectus that the system compared "favorably" with other such systems in its success rate and that it had been used "successfully" to treat gallstone patients. The court also considered important that the clinical studies were material, actual facts bearing on the success of the product, rather than internal projections, and that the information could not be considered trivial as the product's competitiveness was essential to the company's

performance. The omitted study results, the court concluded, were generally inconsistent with statements in the prospectus touting the product's success, and "might have given a reasonable investor pause." (*Kaplan v. Rose, supra,* [1994-1995 Tr. Binder] Fed.Sec.L.Rep. (CCH) [¶] 98,422.at p. 90,877.)

Defendants contend *Kaplan* is entirely distinguishable. Plaintiffs in *Kaplan* identified several specific affirmative statements about the product's success which were rendered misleading by the omission of the information about the test results, whereas plaintiffs in our case are unable to identify any comparable affirmative statements about Harris's continued good health. This is indeed the crux of defendants' argument, which brings us to two cases which, according to defendants, support their position. (*In the Matter of Cytotech Corporation* (1988) SEC Release No. 33-6800; *Hines v. Data Line Systems, Inc.* (1989) 766 P.2d 1109.)

Cytotech was an SEC enforcement proceeding. The corporation in that case was formed to fund medical research which was to be conducted by Dr. L. King. The proposed registration statement informed investors that the company's success depended upon Dr. King's research. It stated that King was 78 years old and that he "consider[ed] himself to be in excellent physical condition." (*In the Matter of Cytotech Corporation, supra,* SEC Release No. 33-6800 at p. 2.) It failed to disclose, however, that King had lymphocytic leukemia, a terminal illness which required that he confine his research to a laboratory located in his home in order to avoid potential infections. The SEC suspended the registration statement

for *Cytotech* on the ground that it was materially misleading.

Defendants argue that because the SCO prospectus included no affirmative statement regarding Harris's physical condition, similar to that contained in *Cytotech*, it was not misleading as a matter of law. We find this reasoning to be flawed, both logically and legally. It would lead to the conclusion in *Cytotech* that, absent Dr. King's statement, there would have been no duty to disclose adverse circumstances directly affecting the performance of the person solely responsible for the research and development of Cytotech's product. If this were the law, issuers of stock could conceal all manner of negative information, material to the company's future, and avoid liability by simply not including a corresponding affirmative statement in the prospectus. Such a result defeats the protective purposes of the securities laws and we do not believe it could have been intended by the drafters of section 11. (See, e.g., *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. at p. 200.)

Both plaintiffs and defendants here seek support from the Washington state case of *Hines v. Data Line Systems, Inc., supra,* 766 P.2d 1109. (See also *Hines v. Data Line Systems, Inc.* (1990) 787 P.2d 8.) *Data Line* involved alleged violations of provisions of the Washington State Securities Act, which are substantially similar to their federal counterparts, as well as state law tort claims. Five days before the Data Line prospectus went into circulation, Peterson, the President and CEO of the company, was hospitalized and diagnosed as having a brain aneurysm which had burst. Two days later additional testing uncovered the presence of additional aneurysms. On the

same day as the release of the prospectus, June 10, 1982, Peterson underwent surgery to correct the burst aneurysm. Following surgery, he was advised by his doctor that he should undergo a similar operation within the year to correct the remaining aneurysms.

The defendants – directors of the company, the underwriters of the stock offering and the attorneys – were aware of the surgery but were not aware of the remaining aneurysms nor of the necessity of further surgery.

The Data Line prospectus contained a section regarding the company's dependence on its key personnel, which specifically identified Peterson and one other. The loss of any of the key personnel, it informed investors, could have a material adverse effect upon the company.

On advice of counsel, defendants decided Peterson's health condition and surgery should be disclosed to potential investors in some fashion before the closing of the stock offering July 14, 1982. However, the disclosure was never made because Peterson was soon discharged from the hospital and he returned to work before the end of June, appearing to have made a full recovery. In December of 1982, Peterson underwent the second surgery. His health problems persisted after that operation and in March or April of 1983 he resigned as president and CEO of Data Line due to health reasons. The company was unable to obtain a market for its product and business ceased the following year.

Investors filed a complaint against the directors of Data Line, the underwriters and the attorneys, claiming the failure to disclose material facts regarding Peterson's

health violated state securities law as well [sic] state tort law. Two outside directors and the corporation's attorney were dismissed on summary judgments. The investors went to trial against the remaining directors and the underwriters and obtained judgments for violations of the Washington State Securities Act.

Defendants appealed the judgment after trial and the investors appealed the dismissal of the attorney and the two outside directors. This resulted in two opinions, one from the appellate court, addressing the appeal from the summary judgments (*Hines v. Data Line Systems, Inc., supra,* 766 P.2d 1109) and the other from the Washington State Supreme Court which affirmed the judgment after trial. (*Hines v. Data Line Systems, Inc., supra,* 787 P.2d 8.) Neither appeal in the *Data Line* matters challenged the essential findings at trial that Peterson's health condition was a material fact and that the failure to disclose it rendered the statements made in the prospectus misleading. Rather the opinions dealt with other issues, such as whether liability should be imposed on various defendants not directly responsible for the prospectus.

Defendants rely on the *Data Line* cases by way of distinguishing them. They argue that the prospectus in *Data Line,* like that in *Cytotech,* contained an affirmative representation that Peterson was in good health. Thus there was a duty in *Data Line* to disclose his serious health problems whereas no such duty arose in our case. There appears to be some question whether or not there was an affirmative statement about Peterson's health in the Data Line prospectus. The appellate court noted that defendants had "represented that Peterson was in good health and then failed to supplement the [prospectus] as

they learned of Peterson's subsequent health conditions." (*Hines v. Data Line Systems, Inc., supra,* 766 P.2d at p. 1114)[3] In the Supreme Court opinion in *Data Line,* the court referred to drafts of the prospectus which "attested to Peterson's good health." (*Hines v. Data Line Systems, Inc., supra,* 787 P.2d at p. 16.)

Neither court quoted any particular affirmative statement from the prospectus regarding Peterson's health and plaintiffs argue vehemently that there was no such statement.[4] Therefore, plaintiffs argue, the *Data Line* cases support their cause because the statements in the Data Line prospectus regarding Peterson's various important roles and functions with the corporation, similar to the statements in the prospectus in our case, created the false impression of a key person who would continue to take an active part in company business. Thus defendants had a duty to disclose factual information regarding that person's impaired or declining health. (See, e.g., *Kas v. Financial General Bankshares, Inc.* (D.D.C. 1984) 105 F.R.D. 453.)

Our remarks regarding *Cytotech* apply as well to *Data Line.* Even assuming there was an affirmative statement in the prospectus regarding Peterson's good health, we

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[3] This quote is taken from a section in the opinion discussing not the securities law violation but rather a state law tort claim for negligent misrepresentation.

[4] To prove their point, plaintiffs submitted a copy of the *Data Line* prospectus to the trial court. The trial court expressly declined to take judicial notice of it. We agree with the trial court that it is improper to go behind the written opinions of another state court in this case in order to review factual material contained in those records.

do not believe that such a statement is a necessary predicate to a duty to disclose known facts regarding his failing health. The duty to disclose information under section 11 arises on the facts of each case. The essence of that duty is whether the statements made in the prospectus – and the statute itself refers to "statements" in the plural – are rendered misleading by the alleged omission. As the court observed in *McMahan & Co. v. Wherehouse Entertainment, Inc.* (2d Cir. 1990) 900 F.2d 576, 579, "[s]ome statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers."

Here the SCO prospectus contained numerous affirmative statements about Harris. Although, as defendants point out, all of this information was required to be included pursuant to the S-K Regulation (17 C.F.R. Pt 229), this does not change the effect on the reader. The prospectus informed the would-be investor that Harris was 49 years old, that he was a paid consultant and chairman of the board of directors, that he had recently served as CEO and President of the company during a difficult time of transition, that he presently served as one of two members of the compensation committee and the audit committee, that he was one of two directors responsible for administering the incentive stock option plan, and that he possessed various stock options, some of which had been granted to him in May of 1993, the same month the prospectus was issued, and which were

exercisable every three months he continued to serve as a consultant and as a director.

While these facts did not expressly represent that Harris was in good health, they arguably conveyed the overall impression of a person whose health permitted a certain level of active participation in company affairs. Consequently, defendants had a duty to disclose information that Harris's declining health, due to a known diagnosed terminal illness, had forced him to begin the process of cutting back his involvement with company affairs. Otherwise investors would be left with a misleading impression.

We emphasize that on appeal from an order sustaining a demurrer, we must assume that plaintiffs will be able to prove all of the facts alleged. (*Fundin v. Chicago Pneumatic Tool Co., supra,* 152 Cal.App.3d 951, 955.) We express no opinion regarding the strength of plaintiff's case. Our holding is a narrow one: on the facts alleged, plaintiffs have stated a duty to disclose information regarding the terminal illness of the chairman of the board of SCO as it affected his continued involvement with the company, notwithstanding the absence of any particular statement in the prospectus affirmatively representing his good health.

b. Materiality

Defendants argue that even if plaintiffs have pleaded facts sufficient to give rise to a duty, there was no need to disclose information regarding Harris's illness because the state of Harris's health was not material to potential investors in SCO. They contend that plaintiffs' allegations

that Harris was the "senior-most executive" at SCO, playing "a central role" at the company are belied by the factual statements in the prospectus. According to defendants, Harris was simply an outside director who resided in Minnesota and was not involved in the management of the company.

Materiality is generally a factual issue. (*TSC Industries, Inc. v. Northway, Inc., supra,* 426 U.S. at p. 450; *Hanon v. Dataproducts Corp.* (9th Cir. 1992) 976 F.2d 497, 500.) Unless reasonable minds cannot differ, it cannot be determined as a matter of law. (*Durning v. First Boston Corp.* (9th Cir. 1987) 815 F.2d 1265, 1268.) The test for materiality has been stated various ways. Is there is [sic] a substantial likelihood that a reasonable investor would have viewed disclosure of the omitted fact as significantly altering the " 'total mix' " of information made available? (*TSC Industries, Inc. v. Northway, Inc., supra,* 426 U.S. at p. 449.) Would a reasonable investor have attached importance to it in considering whether to purchase the securities? (*Kaplan v. Rose, supra,* [1994-1995 Tr. Binder] (CCH) Fed.Sec.L.Rep. [¶] 98,422 at p. 90,875; 17 C.F.R. § 230.405.) Would the disclosure have deterred, or tended to deter, the average prudent investor from buying the offered securities? (*In re Keegan Management Co. Securities Litigation* (N.D. Cal. 1992) 794 F.Supp 939, 944.)

The issue of materiality cannot be decided on the pleadings in this case. While plaintiffs may have overstated Harris's importance to SCO, defendants have understated it. Defendants point out that, unlike *Data Line,* Harris was not mentioned by name in the section of the prospectus entitled "Key Personnel," which states generally that "[t]he company's success depends in part

upon its executive officers. . . . " Harris, as defendants argue, was not even technically an "executive officer."

We do not find these points to be dispositive. No names were singled out in the Key Personnel section of the SCO prospectus. That section referred the reader to a section entitled "Management." Under this heading were listed the "Executive Officers and Directors." Harris's name, as chairman of the board, appeared at the top of this list. The prospectus further identified him as a former President and CEO, albeit briefly, one of two members of three different board committees, and the only member of the board who was paid for his services as chairman of the board and as a consultant to the company.

We believe reasonable minds could differ as to whether a prospective investor might have hesitated to buy SCO stock had defendants disclosed facts regarding Harris's declining health. (see, e.g., *Kaplan v. Rose, supra,* [1994-1995 Tr. Binder] (CCH) Fed.Sec.L.Rep. at p. 90,876.) Therefore we conclude plaintiffs' allegations that this omission was material are sufficient to overcome a demurrer.

Liability under Sections 11(a) (2), 12 and 15

These sections impose liability for section 11 violations on those persons "performing similar functions" as the directors (§ 11(2)(a)), on those who "offer or sell" the securities and on those who "control" persons primarily liable (§ 15). The same threshold showing of liability under section 11 is common to all of these statutory

provisions. (*In re Verifone Securities Litigation, supra,* 11 F.3d at pp. 868-869.)

It is clear from the record in this case that the trial court found plaintiffs' complaint had not stated a prima facie case for a violation of section 11. Consequently the court sustained the demurrers as to all defendants without finding it necessary to reach questions whether the allegations were sufficient to impose additional liability against certain defendants under sections 11(a) (2), 12 and 15. Although the issues have been briefed in this appeal, we believe those questions are better addressed to the trial court in the first instance.

DISPOSITION

Judgment in favor of defendants is reversed. Plaintiffs are to have costs on appeal.

Bamattre-Manoukian, Acting P.J.

WE CONCUR:

Wunderlich, J.

Mihara, J.

MOSKOWITZ V. SANTA CRUZ OPERATION
No. H012757

APPENDIX B

NOT FOR PUBLICATION

IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA

SIXTH APPELLATE DISTRICT

STEPHEN MOSKOWITZ, et al.,	H012757 (Santa Clara County Sup. Ct. No. 735858)
Plaintiffs and Appellants	ORDER MODIFYING OPINION AND DENYING REHEARING NO CHANGE IN JUDGMENT
v.	
THE SANTA CRUZ OPERATION, INC., et al.,	(Filed Dec. 4, 1995)
Defendants and Respondents.	

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It is ordered that the opinion filed herein on November 13, 1995, be modified with the following change:

Delete the full paragraph beginning with the words "Although factually" on page 12, line 18 and ending with the words "personal affairs" on page 13, line 8 and insert the following three paragraphs (including the footnotes which will become footnotes 3 and 4) in its place:

> "We believe *Quarterdeck* is distinguishable. In *Quarterdeck*, the gravamen of the complaint[3] was an insider trading scheme. Plaintiffs alleged

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[3] As part of their petition for rehearing in this matter, defendants asked that we take judicial notice of the complaint in *Quarterdeck*, and we have done so.

that defendants made overly optimistic statements, both in the prospectus and in numerous public reports and press releases, regarding the company's finances, the demand for its products, its past and present earnings and its business prospects; that such statements were false and misleading and were intended to inflate the price of the stock so that certain insiders could sell their shares at a profit; and that one such person was the director Rosen, who sold his shares at a profit and then resigned from the Board, nearly a year after the prospectus had been issued and shortly before the company disclosed low earnings and a substantial drop in sales of its product, causing stock prices to fall dramatically. Plaintiffs alleged, among numerous other asserted material facts defendants failed to disclose, that defendants knew, but did not disclose, that Rosen would remain a director only until he could sell his shares and reap a profit.

Defendants' knowledge about one director's intention to sell his shares and resign from the board at some point in the future was clearly not the crux of the section 11 cause of action in *Quarterdeck*. Moreover, it was sheer speculation whether or when Rosen would in fact decide that profits were such as to justify his selling and resigning from the Board. (See, e.g., *Ultimate Corp. Securities Litigation* (S.D.N.Y. 1989) [1989 Tr. Binder] Fed.Sec.L.Rep [¶]94,522 at p. 93,318, fn. omitted, [no duty to disclose to the investing public the possibility that corporate officers might leave their employ absent a specific reason for thinking that such departure is imminent].)

> In our case, in contrast to *Quarterdeck*, the alleged concealment of information about Harris's withdrawal from company affairs was the heart of plaintiffs' section 11 action. They pleaded that defendants knew of Harris's declining health several months before the public offering, that they were aware his health had forced him to miss meetings and otherwise withdraw from participation in the working group preparing the prospectus, and that they were aware his diagnosis was terminal and that he had been told to wind up his personal affairs.[4]

The remaining footnotes in the opinion should be renumbered accordingly.

This modification does not affect the judgment.

Dated:

Bamattre-Manoukian, Acting P.J.

Wunderlich, J.

Mihara, J.

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[4] Responding briefly to the second point raised by defendants in their petition for rehearing, we emphasize that this case turns on allegations that defendants, at the time of issuing the prospectus, possessed specific knowledge that the Chairman of the Board of Directors was gravely and terminally ill, such that his continued participation in the company could no longer be expected. We do not hold that the issuer has any general duty to disclose or inquire into the health of its officers and directors."

APPENDIX C

Sixth Appellate District No. H012757
S050423

IN THE SUPREME COURT OF CALIFORNIA

STEPHEN MOSKOWITZ Et Al.,
Appellants

v.

THE SANTA CRUZ OPERATION INC. Et Al.,
Respondents

(Filed Feb. 14, 1996)

Respondents' petition for review DENIED. The request for an order directing publication of the opinion is denied.

LUCAS
Chief Justice

APPENDIX D

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SUPERIOR COURT OF CALIFORNIA

COUNTY OF SANTA CLARA

DR. STEPHEN MOSKOWITZ, LENORA ISAACS, JERRY KATZ, IRA ROLLOVER, and DAVID ACKERMAN on behalf of themselves and all others similarly situated, Plaintiffs, vs.	CASE NO.: CV735858 [~~PROPOSED~~] ORDER SUSTAINING DEFENDANTS' DEMURRERS TO THE SECOND AMENDED COMPLAINT (Filed May 20, 1994)

THE SANTA CRUZ OPERATION, INC., a California corporation; LARS H. TURNDAL; DAN E. STEIMLE, DOUGLAS L. MICHELS; LAWRENCE MICHELS; GOLDMAN, SACHS & CO.; and DONALDSON, LUFKIN & JENRETTE SECURITIES CORPORATION,

Defendants.

The Demurrer to the Second Amended Complaint filed by The Santa Cruz Operation, Inc. ("SCO"), Lars H. Turndal, Dan E. Steimle, Douglas L. Michels and Lawrence Michels (the "SCO Defendants") was heard on May 17, 1994. The Demurrer to the Second Amended Complaint filed by Goldman Sachs & Co. and Donaldson, Lufkin & Jenrette Securities Corporation (the "Underwriter Defendants") was also heard on May 17, 1994. The Court, having reviewed the papers supporting and opposing the Demurrers, having heard oral argument of counsel, and being fully advised in the matter and good cause appearing therefore,

IT IS HEREBY ORDERED THAT:

1. The Court declines to take judicial notice of Exhibits A, B, and C to the Declaration of William Audet, and sustains Defendants' objections to receiving those exhibits into evidence.

2. Notwithstanding the Court's decision to decline to take judicial notice of the above-referenced exhibits, the Court reviewed the exhibits and holds that admission

of the exhibits into evidence would not have changed the outcome of Defendants' demurrers as set forth below.

3. The Demurrers of the SCO Defendants and the Underwriter Defendants to the First Claim for Relief is SUSTAINED WITHOUT LEAVE TO AMEND on the grounds that the Second Amended Complaint fails to state a cause of action against any of them for violation of Section 11.

4. The Demurrer of the SCO Defendants to the First Claim for Relief is SUSTAINED WITHOUT LEAVE TO AMEND on the grounds that the Second Amended Complaint fails to state a cause of action against any of them for violation of Section 15.

5. The Demurrer of Defendant Lawrence Michels to the First Claim for Relief is SUSTAINED WITHOUT LEAVE TO AMEND on the grounds that the Second Amended Complaint fails to state a cause of action against him.

6. The Demurrers of the SCO Defendants and the Underwriter Defendants to the Second Claim for Relief is SUSTAINED WITHOUT LEAVE TO AMEND on the grounds that the Second Amended Complaint fails to state a cause of action against any of them for violation of Section 12(2).

IT IS SO ORDERED.

Dated: May 20, 1994

LESLIE C. NICHOLS
The Honorable
Leslie C. Nichols